

EdFUND

FINANCIAL STATEMENTS

FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005

AND

INDEPENDENT AUDITOR'S REPORT

EdFUND

FINANCIAL STATEMENTS

For the Years Ended September 30, 2006 and 2005

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INDEPENDENT AUDITOR'S REPORT

The Board of Directors
EDFUND
Rancho Cordova, California

We have audited the accompanying basic financial statements of EDFUND, a component unit of the California Student Aid Commission, as of and for the year ended September 30, 2006, as shown in the accompanying table of contents. These financial statements are the responsibility of EDFUND's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of EDFUND as of and for the year ended September 30, 2005 were audited by other auditors whose report, dated March 24, 2006, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of EDFUND's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2006 financial statements referred to above present fairly, in all material respects, the financial position of EDFUND as of September 30, 2006, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis on pages 2 through 5 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Perry-Smith LLP

December 20, 2006

EDFUND
MANAGEMENT'S DISCUSSION AND ANALYSIS

For the Years Ended September 30, 2006 and 2005

This section of the EDFUND financial statements presents management's discussion and analysis (MD&A) of its financial performance during the fiscal years ended September 30, 2006, 2005 and 2004. The information contained in this MD&A should be read in conjunction with the basic financial statements following this section.

This report consists of four parts: *The Independent Auditor's Report*, *Management's Discussion and Analysis (this section)*, *Basic Financial Statements* (Balance Sheets, Statements of Revenues, Expenses, and Changes in Net Assets, and Statements of Cash Flows), and the *Notes to the Financial Statements*, which explain in further detail information contained in the financial statements.

EDFUND, a nonprofit public benefit corporation, was created on January 2, 1997, as an auxiliary organization of the California Student Aid Commission (Commission) pursuant to Section 69522(a) of the California Education Code. The creation of EDFUND was authorized by state legislation that empowered the Commission to establish a nonprofit auxiliary to carry out all activities associated with its participation in the Federal Family Education Loan (FFEL) Program. EDFUND is a proprietary component unit of the Commission, and operates under terms and conditions set forth in an annual operating agreement between the two organizations.

In administering the loan program on behalf of the Commission, EDFUND tracks cash activity related to lender claim payments and subsequent collection of defaulted loans. In addition to this activity, EDFUND's bank accounts are also used to deposit funds associated with administrative fees paid by the U.S. Department of Education (ED). These cash transactions are verified, recorded, and transferred to or reimbursed from the Commission Loan Program Federal or Operating funds. As a result of this arrangement, the EDFUND Balance Sheets and Statements of Cash Flows reflect substantial fluidity from one accounting period to another.

Financial Highlights

- In 2005-06, EDFUND administered the guarantee for over \$6.9 billion in new nonconsolidation student loans to borrowers, serving 1,666 colleges and universities. This annual volume represents a 4.5 percent increase compared to the \$6.5 billion in nonconsolidation loans guaranteed in 2004-05, serving 1,440 colleges and universities. To maintain market share the Commission continued to waive insurance premiums through June 30, 2006, and funded the Federal Default Fee from July 1 through September 30, 2006.
- In 2005-06, total loan volume, including consolidation loans, equaled \$10.1 billion, and represents an increase of 29 percent compared to 2004-05. Additionally, consolidation loan volume increased almost 158 percent, from \$1.2 billion in 2004-05 to \$3.2 billion in 2005-06. This increase is consistent with efforts to grow the outstanding portfolio through consolidation initiatives designed to retain and attract borrowers seeking to consolidate their loans.
- Claims, in the amount of \$566 million, were paid to loan holders on defaulted loans in 2005-06, a 10 percent increase compared to the \$515 million paid in 2004-05. Beginning July 1, 2006 the reimbursement on claims submitted for insurance by exceptional performance (EP) lenders decreased from 100 percent to 99 percent. Accordingly, there was a spike in EP lender claims submissions prior to the June 30, 2006 deadline.
- Collections recoveries from defaulted loans for 2005-06 totaled \$293 million, a 24 percent decrease from the \$387 million collected during 2004-05.

EDFUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)
For the Years Ended September 30, 2006 and 2005

- EDFUND contributed almost \$307,000 in grants to four academic institutions in fiscal year 2005-06 as part of the EDSHARE program. However, this is a 65 percent decrease compared to the almost \$865,000 funded in 2004-05 to 14 institutions, due to the completion of the program in 2004-05. The EDSHARE program, established in 2002-03, was a three-year investment in innovative approaches to borrower education, debt management and default prevention. Through EDSHARE, EDFUND provided renewable seed grants to postsecondary schools, colleges and universities.
- Total net assets increased by \$902,630, to \$28.4 million, in 2005-06 due to interest income earned on working capital.

EDFUND's Statement of Revenues, Expenses, and Changes in Net Assets reflect expenses incurred by EDFUND on behalf of the Commission, and their subsequent reimbursement called program service fees. The nature of the operating agreement between the Commission and EDFUND calls for a full reimbursement of all such costs incurred by EDFUND. As a result, program service fees and operating expenses will represent the same amounts after a standard accounting period close. Also specified in the operating agreement is the process where EDFUND initially invests in capital asset purchases and is reimbursed by the Commission as the asset is used in the administration of the Loan Program.

Financial Analysis

| Assets | 2006 | 2005 | 2004 |
|---|----------------------|----------------------|----------------------|
| Cash and cash equivalents | \$ 35,480,343 | \$ 53,713,454 | \$ 44,129,233 |
| Other assets | 43,029,873 | 12,307,866 | 21,835,443 |
| Capital assets, net of accumulated depreciation | 3,080,543 | 4,231,105 | 2,553,390 |
| Total assets | <u>\$ 81,590,759</u> | <u>\$ 70,252,425</u> | <u>\$ 68,518,066</u> |
| Liabilities and Net Assets | | | |
| Current liabilities | \$ 49,007,760 | \$ 39,269,259 | \$ 38,979,088 |
| Long-term liabilities | 4,198,175 | 3,500,972 | 2,672,877 |
| Total liabilities | <u>53,205,935</u> | <u>42,770,231</u> | <u>41,651,965</u> |
| Net assets: | | | |
| Invested in capital assets | 3,080,543 | 4,231,105 | 2,553,390 |
| Unrestricted | 25,304,281 | 23,251,089 | 24,312,711 |
| Total net assets | <u>28,384,824</u> | <u>27,482,194</u> | <u>26,866,101</u> |
| Total liabilities and net assets | <u>\$ 81,590,759</u> | <u>\$ 70,252,425</u> | <u>\$ 68,518,066</u> |

- Total assets exceeded liabilities by a total of \$28.4 million at the end of the fiscal year 2005-06, compared to \$27.5 million in 2004-05 and \$26.9 million in 2003-04. These annual increases are attributed to the interest income earned on cash and cash equivalents. In 2005-06, approximately \$3.1 million of the \$28.4 million in total net assets are invested in capital assets.
- Cash and cash equivalents decreased \$18.2 million, or 34 percent, in 2005-06, compared to an increase of \$9.6 million, or 22 percent, in 2004-05. The current year decrease is related to having a substantial receivable of \$42 million due from the Commission's Operating Fund at year-end. The 2004-05 increase in cash balances resulted from EDFUND spending \$7 million less on program grants and awards compared to the prior year.

EDFUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)
For the Years Ended September 30, 2006 and 2005

- Other assets increased \$30.7 million in 2005-06 compared to a \$9.5 million decrease in 2004-05. The current year increase is a result of having a substantial receivable due from the Commission's Operating Fund at year-end. The 2004-05 decrease was attributed to a \$7 million decline in program grants and awards.
- Capital assets, net of accumulated depreciation, decreased \$1.2 million, or 27 percent, to \$3.1 million in 2005-06, down from the \$4.2 million reported in 2004-05. This decrease is due to limited new asset purchases made in 2005-06. The majority of the 2004-05 asset acquisitions were completed at the end of the fiscal year, thus increasing the amount of depreciation recognized in 2005-06 when compared to 2004-05.

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--|----------------------|----------------------|----------------------|
| Operating revenues: | | | |
| Program service fees | \$ 92,721,005 | \$ 96,549,469 | \$ 95,415,357 |
| Total operating revenues | <u>92,721,005</u> | <u>96,549,469</u> | <u>95,415,357</u> |
| Operating expenses: | | | |
| Salaries and benefits | 55,806,803 | 53,513,604 | 50,632,118 |
| Program grants and awards | 1,763,327 | 6,089,300 | 12,906,953 |
| Collection agency fees | 8,386,382 | 9,705,719 | 7,954,069 |
| Consulting and professional fees | 7,644,945 | 9,022,815 | 6,960,450 |
| Computer expense | 3,494,580 | 3,296,166 | 3,346,357 |
| Other operating expenses | 15,624,968 | 14,921,865 | 13,615,410 |
| Total operating expenses | <u>92,721,005</u> | <u>96,549,469</u> | <u>95,415,357</u> |
| Net operating revenues | <u>—</u> | <u>—</u> | <u>—</u> |
| Nonoperating revenues (expenses): | | | |
| Grant administrative service fees | 907,134 | 669,583 | 602,497 |
| Interest income | 902,630 | 616,093 | 233,781 |
| Grant administrative costs | (907,134) | (669,583) | (602,497) |
| Total nonoperating revenues (expenses) | <u>902,630</u> | <u>616,093</u> | <u>233,781</u> |
| Change in net assets | 902,630 | 616,093 | 233,781 |
| Net assets, beginning of year | <u>27,482,194</u> | <u>26,866,101</u> | <u>26,632,320</u> |
| Net assets, end of year | <u>\$ 28,384,824</u> | <u>\$ 27,482,194</u> | <u>\$ 26,866,101</u> |

- EDFUND's total operating revenues decreased \$3.8 million, or 4 percent from 2004-05. In 2004-05, total operating revenues increased \$1.1 million, or 1 percent compared to 2003-04. The change in program service fees between fiscal years is consistent with overall increases and decreases in operating expenses since these fees represent reimbursements for operating expenses.
- Interest income increased \$287,000, or 47 percent, in 2005-06 compared to 2004-05. In 2004-05, interest income increased \$382,000, or 164 percent compared to 2003-04. Annual results for both years reflect higher interest rates in 2005-06 and 2004-05.

EDFUND
MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)
For the Years Ended September 30, 2006 and 2005

- Total operating expenses for 2005-06 dropped \$3.8 million, or 4 percent, compared to 2004-05. However, certain expense lines experienced significant variances from prior year activity.
 - Salaries and benefits increased \$2.3 million, or 4 percent, compared to the prior year. This increase is primarily attributable to salary increases consistent with the marketplace and a substantial increase in medical and pension benefit costs.
 - Program grants and awards decreased by \$4.3 million from prior year levels due to reductions in outreach spending and completion of the EDSHARE for institutions program in 2004-05. The EDSHARE program, established in 2002-03, was a three-year investment in innovative approaches to borrower education, debt management and default prevention.
 - Collection agency fees decreased \$1.3 million, or 14 percent, compared to 2004-05 and are directly related to the \$94 million, or 24 percent, decrease in gross collection recoveries compared to prior year.
 - Consulting and professional fees decreased \$1.4 million compared to 2004-05, primarily due to a curtailment of consultant fees, limiting the number and scope of all major and operational projects to only those deemed essential for maintaining regulatory compliance and customer service.
 - Other operating expenses increased \$703,000, or 5 percent, compared to prior year. This increase is noted predominantly in postage and travel. Travel expenses are related to the increased services to school and lending partners. Additionally, postage increased as a result of a rate increase and additional printing of materials related to the changes associated with the Higher Education Reconciliation Act (HERA).
- In 2004-05, total operating expenses increased \$1.1 million, or 1 percent, compared to 2003-04. However, certain expense lines experienced significant variances from prior year activity.
 - Salaries and benefits increased \$2.8 million, or 6 percent, compared to the prior year. This increase is attributable to staff additions in client relations marketing to promote and support loan volume growth, and a substantial increase in medical and pension benefit costs.
 - Program grants and awards decreased by \$6.8 million from prior year levels due to reduced spending in outreach programs, including the EDSHARE for institutions program.
 - Collection agency fees increased almost \$1.8 million, or 22 percent, compared to 2003-04 and are directly related to the \$47 million, or 14 percent, increase in gross collection recoveries compared to prior year.
 - Consulting and professional fees increased \$2.1 million compared to 2003-04, primarily in computer consultant fees supporting new generation technology initiatives, and outsourced skip-tracing fees enhancing default prevention efforts.
 - Other operating expenses increased \$1.3 million, or 10 percent, compared to the prior year. This increase is noted predominantly in facilities operations, communications, postage, travel, and prorata. These expenses, with the exception of prorata, are related to the increase in marketing staff as operating costs grow proportionately in support of achieving loan volume growth. Prorata, however, is an uncontrollable expense imposed by the state to cover central administrative services.

EdFUND

BALANCE SHEETS

September 30, 2006 and 2005

| | <u>2006</u> | <u>2005</u> |
|--|----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents (Note 3) | \$ 35,480,343 | \$ 53,713,454 |
| Due from Operating Fund (Note 4) | 41,575,907 | 11,153,701 |
| Prepaid and other assets | <u>1,453,966</u> | <u>1,154,165</u> |
| Total current assets | 78,510,216 | 66,021,320 |
| Capital assets, net of accumulated depreciation (Note 5) | <u>3,080,543</u> | <u>4,231,105</u> |
| Total assets | <u>\$ 81,590,759</u> | <u>\$ 70,252,425</u> |
| LIABILITIES AND NET ASSETS | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,780,967 | \$ 649,914 |
| Due to Federal Fund (Note 4) | 14,768,973 | 5,850,524 |
| Accrued payroll | 5,299,154 | 5,035,066 |
| Accrued expenses and other liabilities | 7,158,666 | 7,733,755 |
| Advance payable to the Commission (Note 2) | <u>20,000,000</u> | <u>20,000,000</u> |
| Total current liabilities | 49,007,760 | 39,269,259 |
| Long-term liabilities (Note 7) | <u>4,198,175</u> | <u>3,500,972</u> |
| Total liabilities | <u>53,205,935</u> | <u>42,770,231</u> |
| Commitments and contingencies (Note 6) | | |
| Net assets: | | |
| Invested in capital assets (Note 5) | 3,080,543 | 4,231,105 |
| Unrestricted | <u>25,304,281</u> | <u>23,251,089</u> |
| Total net assets | <u>28,384,824</u> | <u>27,482,194</u> |
| Total liabilities and net assets | <u>\$ 81,590,759</u> | <u>\$ 70,252,425</u> |

The accompanying notes are an integral
part of these financial statements.

EdFUND

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

For the Years Ended September 30, 2006 and 2005

| | <u>2006</u> | <u>2005</u> |
|---|----------------------|----------------------|
| Operating revenues: | | |
| Program service fees | \$ 92,721,005 | \$ 96,549,469 |
| Operating expenses: | | |
| Salaries and benefits (Notes 7 and 8) | 55,806,803 | 53,513,604 |
| Program grants and awards | 1,763,327 | 6,089,300 |
| Collection agency fees | 8,386,382 | 9,705,719 |
| Consulting and professional fees | 7,644,945 | 9,022,815 |
| Facilities operations and rental expense (Note 6) | 3,960,626 | 3,875,882 |
| Computer expense | 3,494,580 | 3,296,166 |
| Travel expenses | 2,893,344 | 2,511,462 |
| Depreciation expense (Note 5) | 1,934,014 | 1,411,760 |
| Printing expenses | 1,524,151 | 1,523,258 |
| Other operating expenses | <u>5,312,833</u> | <u>5,599,503</u> |
| Total operating expenses | <u>92,721,005</u> | <u>96,549,469</u> |
| Operating income (loss) | <u>-</u> | <u>-</u> |
| Nonoperating revenues (expenses): | | |
| Grant administrative service fees | 907,134 | 669,583 |
| Interest income, net (Note 3) | 902,630 | 616,093 |
| Grant administrative costs | <u>(907,134)</u> | <u>(669,583)</u> |
| Total nonoperating revenues (expenses) | <u>902,630</u> | <u>616,093</u> |
| Change in net assets | 902,630 | 616,093 |
| Net assets, beginning of year | <u>27,482,194</u> | <u>26,866,101</u> |
| Net assets, end of year | <u>\$ 28,384,824</u> | <u>\$ 27,482,194</u> |

The accompanying notes are an integral part of these financial statements.

EdFUND

STATEMENTS OF CASH FLOWS

For the Years Ended September 30, 2006 and 2005

| | <u>2006</u> | <u>2005</u> |
|---|------------------------|----------------------|
| Cash flows from operating activities: | | |
| Cash received from customers | \$ 62,485,725 | \$ 105,644,091 |
| Cash paid to suppliers and vendors | (48,133,877) | (55,736,384) |
| Cash paid to employees for services | (41,435,660) | (40,121,592) |
| Net cash (used in) provided by operating activities | <u>(27,083,812)</u> | <u>9,786,115</u> |
| Cash flows from noncapital financing activities: | | |
| Purchase of defaulted loans | (566,479,948) | (514,827,130) |
| Reimbursements from the Commission of defaulted loans | 566,479,948 | 514,827,130 |
| Receipts from ED | 531,471,703 | 524,127,987 |
| Reimbursements to the Commission of amounts received from ED | (522,753,990) | (522,972,140) |
| Cash receipts from repurchased loans | 14,254,269 | 11,030,191 |
| Cash remitted to the Commission for repurchased loans | (14,254,269) | (11,030,191) |
| Cash receipts from collections | 157,499,245 | 115,018,651 |
| Cash remitted to the Commission for collections | (157,485,435) | (113,903,010) |
| Net cash provided by noncapital financing activities | <u>8,731,523</u> | <u>2,271,488</u> |
| Cash flows used in capital and related financing activities: | | |
| Purchases of capital assets | <u>(783,452)</u> | <u>(3,089,475)</u> |
| Cash flows from investing activities: | | |
| Interest received | 1,957,383 | 1,270,943 |
| Remittances to the Commission of interest received | (1,054,753) | (654,850) |
| Net cash provided by investing activities | <u>902,630</u> | <u>616,093</u> |
| Net (decrease) increase in cash and cash equivalents | (18,233,111) | 9,584,221 |
| Cash and cash equivalents, beginning of year | <u>53,713,454</u> | <u>44,129,233</u> |
| Cash and cash equivalents, end of year | <u>\$ 35,480,343</u> | <u>\$ 53,713,454</u> |
| Reconciliation of operating income to net cash (used in) provided by operating activities: | | |
| Operating income | \$ - | \$ - |
| Adjustments to reconcile operating income to net cash (used in) provided by operating activities: | | |
| Depreciation expense | 1,934,014 | 1,411,760 |
| Change in assets and liabilities: | | |
| Due from the Commission | (30,235,280) | 8,355,639 |
| Prepaid and other assets | (299,801) | 480,653 |
| Accounts payable | 1,131,053 | 50,987 |
| Accrued payroll | 264,088 | 419,454 |
| Accrued expenses and other liabilities | (575,089) | (1,760,473) |
| Long-term liabilities | 697,203 | 828,095 |
| Net cash (used in) provided by operating activities | <u>\$ (27,083,812)</u> | <u>\$ 9,786,115</u> |

The accompanying notes are an integral part of these financial statements.

EdFUND

NOTES TO BASIC FINANCIAL STATEMENTS

1. ORGANIZATION AND OPERATIONS

EDFUND, a nonprofit public benefit corporation, was created on January 2, 1997 as an auxiliary organization of the California Student Aid Commission (the "Commission") pursuant to Section 69522(a) of the California Education Code. Additionally, EDFUND is a component unit of the Commission.

EDFUND was created to administer, operate, and provide services essential to the Commission's participation in the Federal Family Education Loan (FFEL) Program. Most of the expenses incurred for administering the FFEL Program are recorded in EDFUND's financial records while other expenses incurred for administering the FFEL Program are recorded in financial statements of the Commission. In order to fully understand the nature of and the expenses associated with administering the FFEL Program, the EDFUND financial statements should be read in conjunction with the financial statements of the Commission's Federal Student Loan Reserve Fund (Federal Fund) and Student Loan Operating Fund (Operating Fund) as of and for the year ended June 30, 2006.

EDFUND operates under the terms and conditions set forth in an annual operating agreement between the Commission and EDFUND. The operating agreement is renewed or extended annually on October 1. Under the agreement, EDFUND is reimbursed for all expenses incurred on behalf of the Commission in administering the FFEL Program.

In the event that the annual operating agreement should terminate and in the absence of a subsequent agreement, EDFUND assets become the property of the Commission.

2. SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Accounting

The accounts of EDFUND are maintained in accordance with the principles of fund accounting. Fund accounting is a system under which resources are classified for accounting and reporting purposes into funds established according to their purpose.

EDFUND is a proprietary component unit of the Commission. Proprietary component units use the economic resources measurement focus and the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when the liability is incurred regardless of the timing of the related cash flow. The financial statements of EDFUND have been prepared in accordance with accounting principles generally accepted in the United States of America, including all applicable statements of the Governmental Accounting Standards Board (GASB), and statements of the Financial Accounting Standards Board when applicable.

EdFUND

NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(b) Tax-Exempt Status

EDFUND qualifies as a tax-exempt organization under Section 501(c)(3) of the United States Internal Revenue Code and corresponding provisions of California law and, accordingly, is not subject to federal or state income taxes.

(c) Capital Assets

Capital assets are those assets purchased or acquired with an original cost of \$5,000 or more. Additions, improvements or other capital outlays that significantly extend the useful life of an asset are capitalized. These assets are reported at historical cost and are depreciated using the straight-line method over their estimated useful lives of three to five years (term of lease as to leasehold improvements). Costs incurred for repairs and maintenance are expensed as incurred.

(d) Revenue Recognition

Program service fee revenue represents an amount equal to the expenses incurred by EDFUND in administering the FFEL Program on behalf of the Commission. Program service fee revenue is recognized when the related expense is incurred.

Operating revenues and expenses result from exchange transactions associated with the principal activities of EDFUND. Exchange transactions are those in which each party receives and gives up essentially equal values. Nonoperating revenues and expenses, such as investment earnings and grant administrative service fees and costs, result from nonexchange transactions and/or revenues and expenses not earned or incurred in administering the FFEL Program.

(e) Salaries

EDFUND has two types of employees: employees directly hired by EDFUND and civil service employees of the Commission who have been assigned to work for EDFUND (Assigned Employees). Salary expense includes the salaries, wages, and related benefits of both EDFUND employees and the Assigned Employees. The salaries, wages and related benefits of the Assigned Employees are paid by the Commission and EDFUND reimburses the Commission for those amounts.

(f) Related Party Transactions

On January 2, 1997, the Commission advanced \$20,000,000 to EDFUND for operating capital. The terms of the advance have not been clearly defined and, therefore, are determined to be due on demand. As of September 30, 2006, no payments were required. Interest income earned on the unused portion of the advance is reimbursed to the Commission.

EDFUND

NOTES TO BASIC FINANCIAL STATEMENTS

(Continued)

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(f) Related Party Transactions (Continued)

As described more fully in Note 1, the majority of EDFUND's revenues are earned under the operating agreement with the Commission. EDFUND is contingently liable on an operating lease provided for the benefit of the Commission (Note 6).

As described more fully in Note 4, all expenses incurred as a function of performing FFEL services for the Commission or any amounts paid on behalf of the Commission by EDFUND, are fully reimbursable from the Commission.

(g) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

(h) New Accounting Pronouncement

For the fiscal year ended September 30, 2005, EDFUND implemented GASB Statement No. 40, *Deposits and Investment Risk Disclosures – an Amendment of GASB Statement No. 3*. This statement addresses common deposits and investment risks related to credit risks, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, this statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in this statement also are required to be disclosed. Implementation of GASB Statement No. 40 did not have an impact on EDFUND's financial statements as of and for the year ended September 30, 2006 but required additional disclosures related to deposits and investment risks (Note 3).

3. CASH AND CASH EQUIVALENTS

At September 30, 2006, EDFUND maintained cash equivalents of \$34,433,471 and money market deposit accounts in the amount of \$1,046,872. Interest earned on cash equivalents is allocated between EDFUND and the Commission. Interest earned on unused monies of the operating advance is due to the Commission and EDFUND retains the remaining interest earned.

At September 30, 2006 and 2005, the carrying value of the cash and cash equivalents approximated its market value because of its short-term maturity. Interest earned for the year ended September 30, 2006 totaled \$1,957,383 of which \$1,054,753 was allocated to the Commission. Interest earned for the year ended September 30, 2005 totaled \$1,270,943 of which \$654,850 was allocated to the Commission.

EdFUND

NOTES TO BASIC FINANCIAL STATEMENTS

(Continued)

3. CASH AND CASH EQUIVALENTS (Continued)

Custodial credit risk is the risk that in the event of a bank failure, EdFUND's deposits may not be returned. EdFUND does not have a deposit policy for custodial credit risk. EdFUND maintains cash and cash equivalent accounts which are insured by either the Federal Deposit Insurance Corporation (FDIC) or the Securities Investor Protection Corporation (SIPC). The California Government Code requires California banks and savings and loan associations to secure EdFUND's deposits by pledging government securities as collateral. The market value of pledged securities must equal 110 percent of an agency's deposits. California law also allows financial institutions to secure an agency's deposits by pledging first trust deed mortgage notes having a value of 150 percent of an agency's total deposits, and collateral is considered to be held in the name of EdFUND. All cash held by financial institutions is entirely insured or collateralized. As of September 30, 2006, EdFUND had insured cash and cash equivalent balances of \$600,000 and uninsured but collateralized balances of \$36,384,501.

EdFUND does not have a formal investment policy that limits investment maturities as a means of managing exposure to fair value losses arising from increasing interest rates.

4. DUE FROM THE COMMISSION

All expenses incurred as a function of performing FFEL services for the Commission or any amounts paid on behalf of the Commission by EdFUND are fully reimbursable from the Commission. Conversely, all monies received by EdFUND on behalf of the Commission are due to the Commission.

The net amount due from the Commission at September 30, is comprised of the following:

| | <u>2006</u> | <u>2005</u> |
|----------------------------------|----------------------|---------------------|
| Amounts due from the Commission: | | |
| Due from Operating Fund | \$ 41,575,907 | \$ 11,153,701 |
| Amounts due to the Commission: | | |
| Due to Federal Fund | <u>(14,768,973)</u> | <u>(5,850,524)</u> |
| Due from the Commission | <u>\$ 26,806,934</u> | <u>\$ 5,303,177</u> |

EdFUND

NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

5. CAPITAL ASSETS

Capital asset activity for the year ended September 30, 2006 is as follows:

| | Beginning Balance | Transfers and Additions | Transfers and Disposals | Ending Balance |
|--------------------------------------|----------------------|-------------------------------|-------------------------------|---------------------|
| Vehicles | \$ 58,186 | | | \$ 58,186 |
| Computer equipment | 4,345,447 | \$ 563,384 | \$ (29,665) | 4,879,166 |
| Computer software | 3,482,655 | 1,501,804 | | 4,984,459 |
| Equipment, furniture and fixtures | 726,068 | 78,607 | | 804,675 |
| Leasehold improvements | 335,347 | | | 335,347 |
| Construction in progress | 1,404,016 | 43,673 | (1,404,016) | 43,673 |
| | <u>10,351,719</u> | <u>2,187,468</u> | <u>(1,433,681)</u> | <u>11,105,506</u> |
| Less accumulated depreciation: | | | | |
| Vehicles | (29,176) | (11,638) | | (40,814) |
| Computer equipment | (2,925,530) | (859,519) | 29,665 | (3,755,384) |
| Computer software | (2,556,800) | (839,851) | | (3,396,651) |
| Equipment, furniture and fixtures | (463,505) | (125,782) | | (589,287) |
| Leasehold improvements | (145,603) | (97,224) | | (242,827) |
| | <u>(6,120,614)</u> | <u>(1,934,014)</u> | <u>29,665</u> | <u>(8,024,963)</u> |
| Capital assets, net | <u>\$ 4,231,105</u> | <u>\$ 253,454</u> | <u>\$ (1,404,016)</u> | <u>\$ 3,080,543</u> |

Capital asset activity for the year ended September 30, 2005 is as follows:

| | Beginning Balance | Additions | Disposals | Ending Balance |
|--------------------------------------|----------------------|---------------------|-------------|---------------------|
| Vehicles | \$ 58,186 | | | \$ 58,186 |
| Computer equipment | 3,364,373 | \$ 981,074 | | 4,345,447 |
| Computer software | 2,877,248 | 605,407 | | 3,482,655 |
| Equipment, furniture and fixtures | 726,068 | | | 726,068 |
| Leasehold improvements | 236,369 | 98,978 | | 335,347 |
| Construction in progress | | 1,404,016 | | 1,404,016 |
| | <u>7,262,244</u> | <u>3,089,475</u> | <u>-</u> | <u>10,351,719</u> |
| Less accumulated depreciation: | | | | |
| Vehicles | (17,539) | (11,637) | | (29,176) |
| Computer equipment | (2,214,326) | (711,204) | | (2,925,530) |
| Computer software | (2,069,830) | (486,970) | | (2,556,800) |
| Equipment, furniture and fixtures | (319,468) | (144,037) | | (463,505) |
| Leasehold improvements | (87,691) | (57,912) | | (145,603) |
| | <u>(4,708,854)</u> | <u>(1,411,760)</u> | <u>-</u> | <u>(6,120,614)</u> |
| Capital assets, net | <u>\$ 2,553,390</u> | <u>\$ 1,677,715</u> | <u>\$ -</u> | <u>\$ 4,231,105</u> |

EdFUND

NOTES TO BASIC FINANCIAL STATEMENTS

(Continued)

6. COMMITMENTS AND CONTINGENCIES

Operating Leases

EDFUND maintains various operating leases for its main and regional offices. Rental expense for the years ended September 30, 2006 and 2005 was \$3,158,665 and \$3,094,488, respectively. Future minimum rental payments under operating leases that have initial or remaining noncancelable lease terms in excess of one year as of September 30, 2006, are as follows:

| <u>Year Ending September 30,</u> | <u>Gross Obligation Per Lease Agreements</u> |
|--------------------------------------|--|
| 2007 | \$ 3,435,146 |
| 2008 | 3,801,662 |
| 2009 | 4,609,142 |
| 2010 | 4,474,112 |
| 2011 | 4,490,975 |
| Thereafter | <u>32,153,820</u> |
| | <u>\$ 52,964,857</u> |

In May 2001, EDFUND entered into a noncancelable operating lease for the Commission's office facility that expires in 2008. The annual minimum rental payments are included in the schedule above. The Commission reimburses EDFUND for all costs associated with the lease agreement.

The noncancelable operating lease for EDFUND's main offices expires in 2007 and provides for a five-year renewal option. In the event of default by EDFUND or the termination of the operating agreement between the Commission and EDFUND, the leases will be assumed by the Commission for the remainder of the lease terms. EDFUND has entered into an office lease agreement located within two miles of its current main office to house EDFUND and the Commission on one campus. The new complex is build-to-order; with lease payments expected to commence on May 1, 2008 when EDFUND takes occupancy. The expense is included in the future minimum rental payments schedule above, along with an expected extension of the EDFUND main office lease from October 2007 through April 2008.

EdFUND

NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

7. RETIREMENT BENEFITS

EdFUND Employees

Effective July 1, 1997, EdFUND established a defined contribution retirement savings plan comprised of the EdFUND Employees' Retirement Plan 403(b) and the EdFUND Employer Contribution Plan 401(a) for those employees hired by EdFUND. Effective January 1, 2003, EdFUND established the new EdFUND 401(k) Plan. The 403(b) Plan was "frozen" and beginning January 1, 2003 employee voluntary contributions were made into the new 401(k) Plan. In addition, the 401(a) Plan converted to the new EdFUND 401(k) Plan. EdFUND makes a non-elective contribution on behalf of each EdFUND employee. In addition, all regular full-time and part-time employees over the age of 18 and working more than 20 hours per week may contribute on a pre-tax basis from 1 percent to 90 percent of their annual compensation up to the Internal Revenue Service limits. EdFUND contributes a percentage match of 100 percent of employee contributions up to 4 percent of deferred salary.

The Plan is administered by Fidelity Investments. Amendments to the Plan are subject to approval and ratification by EdFUND's Board of Directors.

Total covered payroll for the EdFUND employees was \$41,660,281 and \$40,667,826 for the years ended September 30, 2006 and 2005, respectively. Total employer contributions and employee contributions were \$3,301,383 and \$2,870,924, respectively, for the year ended September 30, 2006, and \$2,870,704 and \$2,736,136, respectively, for the year ended September 30, 2005.

In addition to defined contribution plan benefits, EdFUND also provides postretirement benefits through the EdFUND Postretirement Medical and Life Plan (the "Plan"). The Plan provides for medical, dental, vision and life insurance benefits to employees based on age upon retirement and length of service. The postretirement healthcare benefits are funded on a pay-as-you-go basis and the related expenses and liabilities are calculated using the actuarial-based accrual method. EdFUND uses a September 30 measurement date and assumed that the annual discount rate is 5.75 percent at the end of the measurement periods September 30, 2006 and 2005. EdFUND recognized expense of \$722,229 and \$655,067 for the years ended September 30, 2006 and 2005, respectively. At September 30, 2006 and 2005, there were five and seven retirees eligible to receive benefits, respectively. Included in long-term liabilities is the EdFUND Postretirement Medical and Life Plan of \$3,768,860 and \$3,046,631 for the years ended September 30, 2006 and 2005, respectively. These determinations were computed in accordance with Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*.

EdFUND

NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

7. RETIREMENT BENEFITS (Continued)

Assigned Employees

All assigned employees are eligible to participate in the California Public Employees' Retirement System (PERS). PERS, a multiple-employer defined benefit retirement plan, is administered by a Board of Administration composed of individuals (1) elected by PERS membership; (2) appointed by elected state of California officials; and (3) elected state of California officials. PERS provides retirement, disability, and death benefits. Such benefits are based on the employee's years of service, age, and final compensation. PERS issues a publicly available financial report that includes financial statements and required supplementary information, which may be obtained by writing to California Public Employees' Retirement System, 400 P Street, Sacramento, California 94229-2701.

Assigned employees may participate in PERS at one of three levels; first-tier participants contribute a portion of their salaries to a retirement fund, second-tier employees do not make contributions and Alternate Retirement Program (ARP) participants contribute to a special retirement account for the first two years of State service. The ARP was established for State of California employees hired on or after August 11, 2004. All new State civil service employees are automatically enrolled in ARP for the first two years of employment with the State. After two years, employees will have the option of choosing between the first-tier and second-tier. In addition to the employee's contributions to PERS, the State also contributes into PERS towards civil service retirement benefits. The State's contribution varies annually based on the Budget Act. First-tier employees vest after five years of service and may receive retirement benefits at age 50. Second-tier employees vest after ten years of service and may receive retirement benefits at age 55. As of September 30, 2006 and 2005, there were 45 and 57 employees classified as first tier, respectively, 4 and 5 employees classified as second tier, respectively, and no employees participating in the ARP, supporting direct FFEL Program activities. State records relating to pension benefit obligations and new assets available for benefits are not separately available for EdFUND.

Total PERS expense and funded contributions for the Assigned Employees was \$519,737 and \$595,907 for the years ended September 30, 2006 and 2005, respectively. All contributions were paid as of September 30, 2006.

8. DEFERRED COMPENSATION

EdFUND offers certain employees a deferred compensation plan "rabbi trust" created in accordance with Internal Revenue Code Section 457. The plan, available to select employees permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All amounts of compensation deferred under the plan are placed in trust for participants and their beneficiaries. Included in long-term liabilities is the Deferred Compensation Obligation of \$429,315 and \$443,136 for the years ended September 30, 2006 and 2005, respectively.